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FISCAL IMPACT STATEMENT

LS 7307

BILL NUMBER: HB 1727

NOTE PREPARED: Jan 27, 2005

BILL AMENDED:

SUBJECT: Tax Deduction of Federal Retirement Benefits.

FIRST AUTHOR: Rep. Welch

FIRST SPONSOR:

BILL STATUS: As Introduced

FUNDS AFFECTED: X GENERAL
X DEDICATED
FEDERAL

IMPACT: State & Local

Summary of Legislation: The bill provides an Adjusted Gross Income Tax deduction for part of a federal government pension (including a military pension) received by an individual or an individual's surviving spouse, in an amount that does not exceed the difference between: (1) the maximum benefits payable under Social Security that could have been excluded from federal gross income for the year; and (2) the Social Security benefits actually received by the taxpayer during the year. The bill also provides that a taxpayer may not claim both this deduction and the existing military service deduction or federal civil service deduction.

Effective Date: January 1, 2006.

Explanation of State Expenditures: The Department of State Revenue (DOR) would incur some administrative expenses relating to the revision of tax forms, instructions, and computer programs to incorporate the new military and civil service pension deduction. The DOR's current level of resources should be sufficient to implement these changes.

Explanation of State Revenues: *Summary:* If all civil service and military pension income not already claimed under current deductions is deducted under the provisions of the bill, it could potentially reduce revenue from the Adjusted Gross Income (AGI) Tax by as much as \$35.0 M in FY 2007. The revenue loss could potentially grow by about 2% annually thereafter.

The fiscal impact, however, could be reduced to the extent that: (1) taxpayers (or their spouses) receive Social Security benefits; or (2) taxpayers' pension income exceeds the maximum amount of benefits payable under Social Security that may be excluded from federal gross income. Data to determine these potential offsetting

impacts is unavailable.

Background: This bill provides an Individual AGI Tax deduction for recipients of federal civil service pensions and military pensions beginning in tax year 2006. The bill permits a taxpayer to deduct the amount of civil service or military pension benefits included in the taxpayer's federal AGI. However, the deduction may not exceed: (1) the amount of civil service or military benefits received by the taxpayer that would have been tax-exempt if they had been treated as Social Security benefits; minus (2) the amount of Social Security benefits actually received by the taxpayer that are tax-exempt. The bill prohibits a taxpayer from claiming both the deduction established under the bill *and* the existing military service deduction or federal civil service annuity deduction. Since the bill is effective beginning in tax year 2006, the fiscal impact would begin in FY 2007. Eighty-six percent of the revenue from the AGI Tax on individuals is deposited in the state General Fund, and 14% of this revenue is deposited in the Property Tax Replacement Fund.

The typical maximum excludable Social Security benefit for taxpayers who receive income from military or civil service pensions is indeterminable. In addition, no data is available which indicates the Social Security benefit typically obtained by individuals who receive income from military or civil service pensions. As a result, the estimated impact assumes that all income from military and civil service pensions would be deducted under the bill. The estimate also nets out the cost of the current \$2,000 deductions for civil service annuities and military retirement benefits

Civil Service Annuities: Under current statute, taxpayers may deduct up to \$2,000 in civil service annuity income. State tax data indicates that 4,229 taxpayers claimed deducted approximately \$7.5 M in civil service annuity pay from AGI in 2002. From 1998 to 2002, this deduction declined by an average of 0.9% per year. Thus, the 2006 deduction amount is estimated at about \$7.2 M. Based on U. S. Office of Personnel Management totals, it estimated that there are currently almost 25,000 federal retirees and about 9,000 surviving spouses of federal retirees residing in Indiana. It is estimated that these individuals received civil service annuity payments totaling approximately \$640.9 M during 2004. Based on the 2005 COLA, and the average COLA since 2000 for subsequent years, annuity payments are estimated to total about \$674.3 M in 2006. The amount exceeding the current maximum deduction level totals about \$667.1 M. If this amount is also deducted from AGI, the revenue loss would total about \$22.7 M in FY 2007.

Military Retirement Benefits: Under current statute, a taxpayer may deduct up to \$2,000 in military service income. State tax data indicates that 36,513 taxpayers claimed the deduction for military service pay and retirement benefits in tax year 2002, deducting approximately \$72.2 M in military pay and retirement benefits. U. S. Department of Defense military census and pay rate data suggests that about \$44.7 M of this total is attributable to military retirement. This amount resulted in a revenue loss of about \$1.5 M. This data also suggests that the retirement portion of the deduction is increasing slightly by 0.94% annually. It is estimated that military retirement income in excess of the deductible amounts could potentially total about \$363.0 M in 2006. If this amount is also deducted from AGI, the revenue loss would total about \$12.3 M in FY 2007. The revenue loss could be somewhat lower to the extent that retirement income is already tax exempt (i.e., disability retirement income). Recent DOD retirement pay data does not delineate between taxable and tax exempt military retirement payments to Indiana retirees. However, the proportion that is tax exempt is not expected to exceed 10% of total retirement payments.

Explanation of Local Expenditures:

Explanation of Local Revenues: Because the proposed deduction for civil service and military pension

benefits would serve to decrease taxable income, counties imposing local option income taxes (CAGIT, COIT, and/or CEDIT) could potentially experience a significant decrease in revenue from these taxes.

State Agencies Affected: Department of State Revenue.

Local Agencies Affected: Counties with a local option income tax.

Information Sources: OFMA Income Tax databases; Deborah Williamson, Defense Manpower Data Center, 831-583-2400; Ellen Holmes, Federal Office of Personnel Management (OPM), (202) 606-1782.

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